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TAX EXEMPTION THROUGH TAX CAPITALIZATION A REPLY

In the June number of the *AMERICAN ECONOMIC REVIEW* Professor T. S. Adams has published an article which is, in some respects, a model of scientific discussion. It endeavors, indeed, to deliver some hard blows; but its tone is so courteous and so friendly that it would be impossible to import any personal note into the controversy. This is as it should be. Scientific discussions, unfortunately, are not infrequently beclouded by mere personalities; and when one is incensed, one can not reason with serenity. What we all desire to attain is scientific truth; but the truth is independent of the personality of the one who expresses it.

While, therefore, appreciating to the full the entirely correct, and even generous, tone of the article, and while reciprocating all the kindly personal references, I can not refrain from expressing my conviction that the article in question has failed to substantiate its point. Far from tax exemption through tax capitalization being a fiscal fallacy I think that it can be shown that it is a fiscal truth. And I think, furthermore, that it can be shown that Professor Adams has written without the careful deliberation which the subject demands.

As a preliminary to the discussion, however, I must sound a personal note. Professor Adams' chief purpose is, evidently, to oppose the single tax doctrine by demolishing one of its assumed supports. Professor Adams is a vigorous opponent of the single tax; but, it may be stated, so am I. From my first public debate with Henry George in 1892, I have uniformly opposed the single tax. What was my astonishment, therefore, to be pilloried in the same stocks with so prominent an exponent of the single tax as Mr. Fillebrown. To the undiscerning reader I am put in the same category with the advocates of a project which I have from the very first consistently opposed. And even in the eyes of those who know my real views I am saddled with the sins of the single tax by the charge that in one, at least, of their fundamental points they are applying a theory for which I am responsible. It gives one a strange feeling to be told that he is not what he seems, or what he has thought himself, to be; and that in reality he belongs, scientifically, in the camp of his life-

long opponents. Were this charge true, it would be serious. But, fortunately, it can be shown to be devoid of foundation. So much for the personal side of the matter.

Professor Adams' article may be divided into three parts. First comes the attempted proof of the unsoundness of the general theory, as exemplified in the case of securities. This is followed, secondly, by the contention that the tax-exemption theory applies to land in particular just as little as it applies to anything else. And in the third place comes the argument as to the diffusion of the unearned increment. This third part has logically nothing in common with the first two parts. It is added by Professor Adams in his endeavor to nail another spike into the coffin of the single tax.

For purposes of convenience we shall take up first the application of the capitalization theory to land. I am in thorough agreement with Professor Adams as to the inapplicability of the doctrine to land. But I differ with Professor Adams as to the reasons advanced by him. In other words, I disagree with the single taxers, not on the ground that the capitalization theory is unsound, but solely on the ground that the application which they make of the capitalization theory is illegitimate. It does not follow that, because a conclusion is unsound, the major premise must be false. In his desire to prove the error of the single-tax conclusion Professor Adams has attacked the major premise, which is true, and has left unnoticed the minor premise, which is false. According to his view, the single taxers have made a legitimate use of an incorrect theory; according to my view, they have made an illegitimate use of a correct theory.

All this was explained many years ago. The entire subject of the so-called rent-charge (or, as the French call it, the fixity or the immutability) theory of the land tax was set forth over two decades ago,¹ in a chapter calling attention to "the real weakness of their arguments." To show the error of the single tax in this respect would thus be, from a scientific point of view, to whip a dead horse. The scholars who have given the most effective refutation of the rent-charge theory of the land tax are precisely the ones who have done the best work in developing the general theory of capitalization.

Although it is thus an old story, it may be worth while,

¹ *The Shifting and Incidence of Taxation* (3d ed., 1910), pp. 174-183 and 221-226.

nevertheless, to recapitulate the reasons why the capitalization theory can not be legitimately used as the advocates of the rent-charge theory of land taxation attempt to do.

In the first place a necessary condition of the capitalization theory is the exclusiveness of the tax. The tax on land is everywhere only a part of the system of taxation. In the United States it is a part of the general property tax. To the extent, therefore, that there are other taxes, the land tax can not be considered an exclusive tax and the foundation of the theory disappears.

In the second place, assuming that the land tax were, in reality, what the single taxers would like it to be—a single or exclusive tax—the particular conclusions drawn by the single taxers would still not follow. Professor Adams refers in his article (pp. 274-275) to the dissenting opinion of the minority of the Mayor's Committee on Taxation in which it is claimed that no direct answer is made in the majority report to the rent-charge or capitalization theory. No secret, I trust, is being disclosed by the statement that the majority report was drafted by me and that the only reason why no reply was made to the rent-charge theory was that it was scarcely mentioned in any of the arguments advanced. There was, I think, an incidental reference to it in one of the briefs; but it was not urged in the oral hearings and was considered so insignificant that it was not discussed at all in the meetings of the committee. It was, therefore, deemed undeserving of mention in the majority report.

In order, however, to dispose of the matter, I may add that in the passage quoted from the minority report, the whole subject is thrown into confusion by the use of the words "the present owners of land" in the last sentence. The essence of the capitalization theory of incidence is the distinction between the original owners and the new purchasers; it being entirely true, as will be seen below, that, in so far as the conditions of the theory permit, new purchasers of land, for that matter like new purchases of anything else under similar conditions, do buy themselves free of tax. It is, however, incorrect to assert that all "present owners" are free from existing taxes on the ground that they have bought themselves free. Many, or even most, of the "present owners" may not have bought themselves free at all, simply for the reason that they owned the land before the present burdens were imposed or increased. To confuse all present landowners with tax-free holders of land is the real weakness in the argument.

It is thus the fallacious minor premise, and not, as Professor Adams supposes, the major premise, which invalidates the conclusion. If the single tax were really in fact, as well as in name, a single tax, that is, if nothing else but land values were taxed in the entire country; if, in the second place, due notice were given in advance of the exact and permanent rate of this single tax; and, most important of all, if the tax were thereafter applied exclusively to those individuals who subsequently bought land, then, and then only, would the conclusion of the single taxers be justified as to burdenless taxation. It is precisely because these conditions were lacking, that the proposal of the single taxers aroused such opposition in New York. Their scheme practically meant not burdenless taxation, but extremely burdensome taxation to the mass of existing landholders who were not, for the most part, new purchasers. And it was for that reason defeated.

It is plain, therefore, that whether or not the general theory of capitalization is true, the attempted application of the theory to land is unwarranted. We have shown that the minor premise of the argument is false. If, now, we can show that the major premise is sound, the entire contention of Professor Adams will be disproved, and his conclusion as to the land tax—sound though it be—will be shown to rest upon a false reasoning. According to him, the conclusion of the single taxers is fallacious because the general theory is erroneous; according to the argument just adduced the conclusion of the single taxers is fallacious because the minor premise is erroneous. If, now, we can show that the general theory, or major premise, is correct, Professor Adams will be convicted of a double mistake; namely, of opposing a correct major premise and of upholding an erroneous minor premise. To Professor Adams I seem at fault for advancing an untenable general theory while the single taxers have been “inexorable in their logical processes” (p. 276). I trust that it has at least been shown that the single taxers are the opposite of “inexorable in their logical processes.” It now remains to defend the general proposition.

II

Professor Adams discusses the capitalization or amortization theory of incidence under the head of “tax exemption through tax capitalization”; and treats of the general theory in con-

nection with its application to corporate securities. Here he inadvertently gives an erroneous statement of my practical conclusions. He states (p. 272) as my conclusion: "that where a corporation tax is exclusive it would be legitimate to levy another tax on new purchasers of stock." This implies that what was advocated was a special tax on the corporation and another special tax on the shareholders. What was really under discussion, however, was the legitimacy of a general income or a general property tax in cases where a special corporation tax already exists—which is a very different matter. The statement was² that since the purchaser buys himself free of tax "an additional tax on the new shareholder, in common *with all other recipients of income*, would thus really constitute no injustice to him." But even then the qualification was added that "the practical difficulty would, of course, consist in distinguishing between old and new owners." It is precisely the failure to call attention to this consideration that constitutes the weakness of the single-tax argument; and I must protest, in all deference, against being made responsible for a conclusion against which I had particularly sought to guard myself. The actual generalizations which I do urge are of a different kind.

It is the same failure to observe distinctions which leads Professor Adams to make me responsible for what he calls (p. 276) "the immoral doctrine" of the single taxers, that a new tax should be heaped upon a new tax until the whole value of the property is gone. He does, indeed, say that I "apparently reject such conclusions"; but he intimates that this is so because I am not relentless in my logic. And on the next page (p. 277) he refers to "the radical conclusions of those writers who would indefinitely increase the rate of taxation upon land and securities." To my knowledge there is no writer who has ever advocated an "indefinite increase" of the rate of taxation upon securities; and the attempt to make me, by inference, responsible for any such doctrine rests, as we shall see in a moment, upon an inability to distinguish between exclusive and inclusive taxes.

This brings us to the core of the argument: namely, the alleged unsoundness of the theory of tax exemption through tax capitalization. This is characterized as "a doubtful doctrinal tool." The entire attempt at refutation is, however, contained in a few lines on pages 273 and 278.

² *Essays in Taxation* (8th ed.), p. 309.

Let us take up first the subject of exclusive taxation. Objection is made to my statement as to the inclusiveness or exclusiveness of the old tax and the contention is advanced (p. 273) that "it is the exclusiveness or the inclusiveness of the new tax rather than the old tax which counts." Let us see.

There are two possible cases which are of interest to us here. Let it be assumed that a special or exclusive tax on some form of property, whether corporate or land, already exists. Let us further assume that in one case the government imposes a new general tax on everything, including corporations and land; or, secondly, that on the other hand it imposes a new special or exclusive tax on corporate securities or land.

Let us take up first the case of the new general tax, which is discussed by Professor Adams at the top of page 273. He maintains that under these conditions the tax will be legitimate, because it is general. For everybody has to assume a new and heavier burden, so we are told, and it will be legitimate "to place this burden on stockholders, particularly new purchasers, who are paying through a corporation the exclusive tax." Is this true? There are two points involved here. Why does Professor Adams speak of "stockholders, particularly new purchasers"? Why, if the theory of capitalization is, as he contends, untrue, does he make any distinction between new purchasers and other stockholders? If the test is simply the generality of the *new* tax, what is the ground for such a distinction, and why should the new purchasers be singled out as being "particularly" amenable to the new tax? As soon as Professor Adams draws a line, as he does here between new purchasers and other stockholders, he virtually abandons his contention. The new purchasers can be singled out "particularly" only if the capitalization process is assumed; and if the capitalization process is true of a new tax, why is it not true of an old tax?

But, in the second place, and entirely apart from the "particularly new purchasers," is it true that a new general tax is always legitimate? Does not the question of the legitimacy of a new general tax depend in part upon the truth of the capitalization theory as applied to the old tax? And is it not a fact that in practical fiscal programs this is the consideration which often weighs most heavily with the legislator? In Italy, for instance, when a new general income tax was imposed, land was expressly exempted from the operation of the law, on the ground

that it was already subject to a special land tax. The same argument was advanced recently in New York during the discussion of the suggested income tax, one of the leading financiers maintaining that any attempt to include income from land in the general income tax was unwarranted because of the fact that land was already subject to what was practically an exclusive or special property tax. On the other hand, this practice has not been followed in many leading countries, including our own, which impose a general income tax. Why did the Italian statesmen consider a new general income tax illegitimate, and why did the American statesmen consider a new general income tax legitimate?

The answer is plain. It depends upon the theory of capitalization as applied to the old tax. If the theory of tax capitalization is untrue, then the new tax, no matter how general it may be, is illegitimate. For if all landholders, for instance, are already subject to an exclusive tax, and if they really bear the burden of that tax, it would be plainly imposing upon them a double taxation to include them in the new general tax. I do not, of course, mean to say that it may not be desirable to tax land at a higher rate than other property; but I do mean to say that if the object of the statesman is to achieve, as far as possible, equality in taxation by taxing all classes and all incomes alike, then it is illegitimate to levy a new general tax on all property or income in the presence of an existing exclusive tax on some form of property or income. What is needed in such a case is not a new general tax, but a partial or exclusive tax designed to redress the inequality of the old exclusive tax.

But if, on the other hand, the theory of tax capitalization is true, then the new general tax is legitimate. For if the old tax is an exclusive tax and if the theory of capitalization is true, new purchasers of the property would buy themselves free of tax. If the old tax has been in existence for some time, it is likely that most of the property will be in the hands of the new purchasers. It has been estimated, for instance, that in the American cities land on the average changes hands every twenty years; and in the case of securities the period is apt to be much shorter. But if the theory of capitalization is true and if the new purchaser has practically bought himself free of tax, there is no objection to levying a new general tax, because the new tax will hit the new purchasers of that particular property, like the

owners of all other property, only once. There will still, of course, be a remnant of original owners who will suffer. But the longer the old tax has been in existence, the less weighty will be the objection.

We see, therefore, that under the conditions mentioned by Professor Adams, namely the imposition of a new general tax on top of an existing exclusive tax, the new tax will be legitimate if the theory of tax capitalization is true, and that it will be illegitimate if the theory of tax capitalization is untrue. The legitimacy, therefore, of the new general tax depends not on the character of the new tax, but on the application of the theory of capitalization to the old tax.

This is, however, only one half of the argument. For let us suppose that the new tax is not a general income or a general property tax but a special or exclusive tax. According to our critic this new exclusive tax is always illegitimate. He tells us (p. 273): "generally speaking, the new tax will be legitimate *or not* according as it is general or not." This conclusion, it may be stated with all due deference, is just as unsound as the previous one. If the theory of tax capitalization is untrue, of course the new tax would be illegitimate, for this would be heaping Pelion on Ossa, and would simply be intensifying an inequality which already exists. But if the theory of tax capitalization is true, the new exclusive tax will be as legitimate as any exclusive tax can be. The reason why an exclusive or special tax is imposed is that the property or the income taxed is presumed to possess qualities which properly single it out for special taxation, as, for instance, a special tax on monopolistic public service corporations. Whether this new tax may properly be imposed in the face of an already existing tax on such corporations depends largely on the question as to whether the existing exclusive tax is really a burden on the corporation or its shareholders, or to what extent the existing shareholders have bought themselves free from tax; that is, have made allowance for the existing tax in the market price which they have paid for their shares. Thus it does not follow, as Professor Adams thinks, that a new special tax must always be illegitimate. If that were true, he would be indicting a large part of the program of state tax reform, of which he is so eminent a representative; for in many states the general property tax is being split up into a series of special taxes.

It seems, therefore, that Professor Adams' contention has

been disproved. I do not, of course, deny that the legitimacy of a new tax may depend upon the characteristics of the new tax. But what I do maintain is the fallacy of the contention that in the presence of existing taxes the character of the old tax has nothing to do with the legitimacy of the new tax. That is the real point at issue. Under the conditions assumed by Professor Adams, namely the existence of an exclusive tax, we have shown that a new general tax may be sound or unsound (and not always sound, as he says); and, on the other hand, that a new special or exclusive tax may also be sound or unsound (and not always unsound, as he says); and we have likewise shown that the criterion (not, of course, the only criterion) of the legitimacy of the new tax is not whether the *new* tax is general or exclusive, but whether the theory of tax capitalization does or does not apply to the *old* tax. If the old tax is a general tax, the theory of capitalization, of course, can not apply, and the new tax, whether general or exclusive, must stand on its own merits. But if the old tax is an exclusive tax, then the legitimacy of the new tax depends, in part at least, on whether the theory of tax capitalization does or does not apply. The real test, therefore, is the exclusiveness or inclusiveness of the old tax and not that of the new tax. I submit that what Professor Adams calls the "impossibly difficult" (p. 278) distinction between exclusive and inclusive taxes is a very simple one indeed, if attention be centered on what is the real point of the controversy. And I further submit that what is calculated to "make mischief" (as Professor Adams asserts) is not the well-recognized distinction between exclusive and inclusive taxes; but the confusion of thought in failing to distinguish between new and old taxes.

III

All this, however, is really preliminary to the main argument. So far as we find any definite theory in the article under review, the chief thesis seems to be that one can not, through the process of capitalization, buy himself free from a tax. It is asserted (p. 271) that new purchasers who are reputed to go tax free "do not, in a genuine or practical sense, accomplish any such impossible result."

This thesis is supported by two contentions:

1. That the person pays the tax through the lowered interest

rate which he is compelled to accept as a result of the tax (p. 278).

2. That the person pays the tax through an increase in the price of consumable goods (p. 277).

Incidentally remarked, these two phenomena seem to be opposed to each other. Assuming, however, for the sake of argument, that what is meant is that the first result will ensue in some cases and the second in others, it still remains true that no argument is adduced to show how the new purchaser is supposed to pay the average rate. The entire subject is disposed of in a few lines, with an undue brevity. Let us scrutinize the statement a little more closely.

In the first place, Professor Adams seems to commit himself definitely to the position that through an effect upon interest rates every one pays taxes, and does so at the same rate. "When a man buys durable property, he capitalizes its net value or income at a rate which is lower when the general tax burden is high, and higher when the general tax burden is low" (p. 278). The only argument in support of this contention, however, is the statement that "it [the rate of capitalization] registers automatically the average tax burden." This obviously means that taxes on capital are diffused among all owners of capital through a decrease in the general rate of interest. This is indeed a new proposition, and it would be important if true. But is it true? Is the rate of interest affected by taxation? Does the general taxation of all industries or the special taxation of any one industry reduce interest rates so that all owners of capital bear the burden? The mere claim by Professor Adams to this effect does not suffice. It is certainly something not to be found in any of the books; and Professor Adams owes it to his readers to prove the point.

In the absence of any such proof, let us attempt an analysis ourselves. Suppose, for example, that a special tax is imposed on the securities of the Steel Corporation. What will be its effect upon interest rates?

New investors in steel securities will, of course, demand the current return on their investment; *i.e.*, they will demand the current rate of interest above the tax. The problem now is: Is this current rate of interest affected by the tax?

There are here two possibilities: the tax may be shifted to the consumer or it may be borne by the producer. Professor Adams (p. 277) says that "any unusual burden is borne by the

consumer.” This is, be it said in passing, inaccurate; as under certain conditions, for instance those of monopoly, the tax will not be shifted to the consumer. But suppose, for the sake of argument, that the tax is shifted to the consumer. What will be the effect upon interest rates?

It is of course true that if the tax is shifted, the price of the steel products will advance. This may, under certain conditions, lead to a smaller demand and thus to a reduced output. A reduced output again may tend to lessen the rate of interest because of the diminished demand for the capital invested in production.

Let us, however, look at the reverse side of the argument. If prices of steel products advance, the funds available for saving will manifestly be diminished. But this obviously means a reduction in the supply of capital and this reduction in the supply of capital again will clearly be likely to increase the interest rate.

It is manifest, then, that the two above forces tend to counteract each other. Therefore, if the tax is shifted, the effect upon the interest rate is entirely problematical. The rate of interest may remain unchanged; it may move up a little, if one set of forces is stronger; or it may move down a little, if the other set predominates. What justification then is there for the claim that the interest rate “automatically registers the tax burden”?

Suppose, on the other hand, that the tax imposed on the corporate securities is not shifted to the consumer. As has been pointed out elsewhere,³ this not infrequently happens. Suppose, in other words, that the producer should decide not to increase the price of the commodity. Everything would then depend upon the fact as to whether he would reduce the output. Under certain conditions of monopoly production, the sole effect of the tax would be to diminish the high profits of the producer. It is only when these profits are reduced to a point where the producer will prefer to diminish his output that there would be, theoretically, a lessened opportunity for the investment of capital. And it is only in this exceptional case, and to this very slight extent, that we could talk at all of a tendency toward lower interest rates.

It must not be forgotten, however, that a great part of a country's capital is invested in land. When Professor Adams speaks of how “any unusual burden is borne by the consumer” he forgets all about the case of land. Does he seriously desire

³ *The Shifting and Incidence of Taxation* (3d ed., 1910), pp. 338-366.

to take the position that the imposition of a tax on land or on land values will affect interest rates? Does he mean to say that all taxes on the selling value of land are shifted to the consumer? But if a tax on land is often not shifted, and if so large a part of a country's capital is invested in land, what becomes of the "automatic registration theory"?

Summing up this entire argument, we see that it is, indeed, true that the imposition of a tax on capital may, in some cases, have a depressing effect upon the rate of interest. This point has, indeed, not been adequately emphasized before, and Professor Adams deserves credit for calling attention to it. But we must be careful not to overemphasize the point. As we have just shown, the tendency of taxation to depress interest rates is, in the first place, exceptional; it is, in the second place, often counteracted or actually outweighed by the opposite tendency; and, in the third place, even in the rare cases where it exists, it is so slight as to be negligible. But at all events, and beyond the peradventure of doubt, there is no basis for the statement that taxes are automatically registered in the interest rate.

With the disproof of this theory, the entire structure erected by our critic collapses. In point of fact, when we come to consider the few lines of argument more closely, we find that he really shares the very theory which he opposes; and that the failure to recognize this fact is due to his reluctance to accept the existence of a "taxless field" to which investors can repair. This is closely connected with his failure, mentioned above, to grasp the conception of an exclusive tax.

The capitalization theory or, as I have called it in my book more properly, the amortization or absorption theory, is nothing but an extension of the ordinary theory of value and wealth. Capital is capitalized income. When a man buys a piece of durable property he pays for it an amount equal to the capitalization of the estimated recurrent annual income. Therefore, as a permanent tax is one of the items of outgo which must be deducted from the gross receipts in order to reach the real income, the capitalization theory of taxation is simply an application of the capitalization theory of wealth. Nothing that Professor Adams urges is opposed to the incontrovertible fact that when a man buys a bond or piece of land or any other class of capital subject to a fixed and recurrent tax, he makes allowance for the tax in the purchase price. That is all there is to the theory

of tax exemption through tax capitalization. Professor Adams states this himself when he says (p. 273) that "at any given time purchasers of taxed property stand on the same footing as purchasers of exempted property." How can the purchaser of taxed property (*i.e.*, with his property subject to taxation) stand on the same footing as the purchaser of exempted property (*i.e.*, of property not subject to taxation), unless the purchaser of the taxed property does not feel the burden of the tax. How can the man who is not taxed "stand on the same footing" as the man who is taxed, unless the tax on the latter is only an apparent, and not a real, tax? When Professor Adams says (p. 273) that "there is no exemption through capitalization, but only equalization of the burden through competition" he is asserting something which, with all due deference, I must characterize as unsound. For the one thing means to me precisely what the other does. Capitalization in general economic life is brought about only through an equalization in the rate of return. Capitalization is equalization; equalization is capitalization. When Professor Adams objects to the one and not to the other, he is tilting against a windmill. In order to refute the exemption-through-capitalization theory, he will have to refute the entire modern doctrine of capitalization as capitalized income. And this, I venture to assert, is a rather large order.

On page 278 Professor Adams virtually gives away his entire argument. He states that the subsequent purchaser, who according to Professor Adams' view does not buy free of tax, "buys free from any excess of tax over the average rate." But this is precisely what I say. Substitute the words "taxless field" for the words "average rate" and we have a statement of the capitalization theory. To be entirely exact, indeed, it may be well to speak of "freedom from the excess over the usual burden." But it is far simpler, and really not susceptible of misconstruction, to speak of the taxless field, and to ignore the various obscure, insignificant, indirect, and wholly negligible effects of taxation upon interest rates. When Professor Adams says that the new purchaser pays the average rate of taxation and that he bears no special burden and reaps no special benefits, he asserts precisely what the capitalization theory maintains. When a new purchaser is said to buy himself free from taxation, what is meant is that he buys himself free from any exclusive tax, or any excess of tax above the average rate. If a special tax is imposed

upon any particular class of securities or corporations over and above the general rate of taxation, the capitalization theory shows that the new purchaser buys himself free of this special tax and pays only what the investors in other classes of corporations pay. And, again, if a new purchaser is exempt from a general tax, as, for instance, if he buys a tax-free bond under our federal income-tax law, the capitalization theory shows how the new purchaser amortizes the exemption by paying more for the bond; and that, therefore, he really is not exempt, but pays in substance the same rate as other income-tax payers. In reality, therefore, Professor Adams accepts the conclusions of the capitalization theory. He erroneously thinks that he has demolished the theory, whereas all that he has done has been to advance an untenable doctrine of the relation between taxation and the rate of interest.

Everything that is true in Professor Adams' conclusions has previously been stated by others. When he contends that no investor in capital can pay more than the average rate of taxation he says, virtually, that inequalities in the taxation of durable property are wiped out. This is, however, what every upholder of the capitalization theory says. The only difference between us is that in my view the inequality is wiped out by the process of capitalization, which is an application of a generally accepted economic theory; while in Professor Adams' view the inequality is wiped out by a change in interest rates, which as we have shown is by no means necessarily true. As has been elsewhere stated,⁴ inequality of taxation is the corner-stone of capitalization. The longer the reader reflects on this, the less will he agree, let us hope, with our critic as to the "impossibly difficult" conception of an exclusive or unequal tax.

It may not be amiss to point out some of the practical consequences of the theory at issue. A few years ago, when the sixteenth amendment was being discussed, the present writer made a rather extended investigation into the subject of tax-free bonds, the results of which were published in part.⁵ All this had to deal with the every-day practical aspect of the taxless field, which our critic is so loath to recognize. In the recent discussion at Washington as to the desirability of substituting information-at-source for collection-at-source in the income tax, quite a

⁴ *The Shifting and Incidence of Taxation* (3d ed.), p. 223.

⁵ *The Income Tax* (2d ed., 1914), pp. 605-613.

number of briefs were filed by the contending parties which took for granted, as a part of ordinary financial practice, the truth of the tax-exemption-through-capitalization theory. Thus in one of the briefs⁶ the writer, after quoting a statement on the subject of the 1914 discussion of the matter before the National Tax Association, says: "Professor Seligman is right. The tax-free covenant today represents the capitalization of the tax." And he thereupon proceeds to give a number of facts to substantiate his statement. A little later⁷ in quoting the discussion of the tax-free clause, he adds: "The investment banker can say, from actual experience, that Professor Seligman's theory accords with the facts."

Another brief,⁸ after quoting passages from several of my works, acknowledges the truth of the statement and gives in detail the differences in market value between the tax-free and non-tax-free bonds at various dates since the passage of the law. It concludes, as incontrovertibly proved, that the new purchaser of the tax-free bonds really loses the benefit of the exemption by having to pay so much more for the bonds. Of course, if the new purchaser loses the benefit of the exemption, he would by the same argument rid himself of the burden which might be imposed by a special tax. That is, in the latter case he would buy himself tax-free just as in the former case he would, through the increased purchase price, saddle himself with the capitalization of the exemption. Finally, in still another brief,⁹ the same point is again labored from the point of view of the bond market.

Truly he has a stout fight on his hands who attempts to controvert a doctrine the practical application of which is attested by all the experts in the stock market.

There is one other point that deserves passing mention in this connection. Professor Adams, like many writers who have paid

⁶ *Income Tax. Information at the Source vs. Withholding at the Source. Memorandum of Argument by Counsel for Investment Bankers Association of America*, pp. 7-12.

⁷ *Ibid.*, pp. 15-16.

⁸ *Statement of the First National Bank of Chicago and the First Trust and Savings Bank of Chicago in Favor of Deduction at Source, etc.*, pp. 5-7 and pp. 25-27.

⁹ *United States Senate Committee on Finance. Memorandum Relative to Pending Revenue Bill. Withholding versus Information. Submitted on behalf of Investment Bankers Association of America*, pp. 16-22.

attention to the general problem, is much troubled by what he calls the diffusion of taxes. This is, indeed, one of the most difficult parts of the whole theory of finance. I have attempted to grapple with it, in one aspect at least, in the chapter of my work on *Incidence* where attention is called to the elision of taxation. Our critic's treatment of the subject, however, suffers from two serious defects. He does not distinguish diffusion, which has always been regarded as the result of the shifting or repercussion of taxation, from capitalization. For, as has been frequently pointed out, capitalization is the opposite of shifting. In the second place, even assuming that he means by diffusion what I have called elision of taxation as the joint product of diffusion and capitalization, he errs in unduly generalizing this process. For, as has been pointed out, capitalization applies only to a tax on certain kinds of property; while diffusion or shifting applies again only to certain taxes on commodities or industries. Elision of taxation is, therefore, not a universal phenomenon: there are many taxes which are never shifted or diffused, and there are others which are never capitalized.

IV

This brings us to Professor Adams' final point: namely, the diffusion of the unearned increment.

With much of what he here says I am in agreement; but I can not refrain from pointing out that, in the ardor of his enthusiasm he has somewhat exaggerated the situation. Take for instance the passage on page 279 where, in discussing the unappreciated value of the diffused increment, he cites the early cultivation of farms. He omits here to mention an important consideration. Is not the fact that the farmers can not make the current rate of wages on their farms a sure indication that they had better be doing something else? Ought we not to consider carefully the social loss of misdirected labor and capital; and ought this not to count on the other side of the balance? The same considerations apply to the railroads, mentioned on the next page, where the early extensions of railroads certainly represent, for the time being at least, a relative diminution in social productivity. Mr. Hurd has pointed out the same fact as to the social loss involved in urban real estate where unsuitable improvements are put or kept on the land.

Another point in which Professor Adams' conclusions may be

queried is the passage on page 280 where he contends that the manufacturer is forced to give back to the community the unearned increment which he is supposed to receive. This contention seems very doubtful. Is it true that manufacturers frequently, or indeed ever, look upon a piece of land as a matter of speculation? Professor Adams virtually asserts that the manufacturer located on "non-increment" land can not compete with the manufacturer located on "increment land." Does the manufacturer, it may be inquired, manufacture simply for the love of it? Why then does he not merely allow his land to increase in value, without bothering with the details of manufacturing? Unless he is compelled to manufacture in order to raise enough money to pay the carrying charges and thus preserve the title to his land and the future increment, the point is not well taken.

There are, also, other contentions in the article that seem to be of doubtful validity. Thus, take the passage on page 283 in which it is claimed that there is no justification for an increase of a tax on land "based upon . . . the general class of arguments which Mr. Fillebrown and his associates have made so familiar." If what is meant by this is the misapplication of the capitalization argument, the statement is quite correct. But if it is meant that there are no general arguments in favor of an increase of land taxes, the statement is, I think, untrue. At all events it is a mere assertion, unsupported by argument. In a separate memorandum in the report of the Mayor's Committee on Taxation an attempt has been made to give some of the reasons which make a moderate extra tax on land desirable.

Finally, the passage on page 282, where reference is made to the question whether it would pay the state to purchase all privately held land at existing prices, is questionable. For, even granting the truth of the diffusion theory of the unearned increment under private ownership, the problem of diffusion under public ownership is a very different thing. To mention only one consideration, the entire problem of the efficiency of public administration is involved.

V

Summing up the points made above, I should frame the general indictment against Professor Adams as follows:

1. He has exaggerated the doctrine of the diffusion of the unearned increment.

2. He has tilted against the wrong horse, opposing the general theory of exemption through tax capitalization, instead of showing the fallacy involved in attempting to apply this doctrine to land in the way the single taxers do. In other words, he has committed the logical error of attacking the major, instead of the minor, premise.

3. He has shown an inability to distinguish between exclusive or inclusive taxes and has confused new and old taxes. He has been unable to recognize that the so-called "equalization through competition" means precisely the same thing as resort to the taxless field, which he is reluctant to accept.

4. He has given a mutually contradictory theory of incidence, failing to observe that shifting and capitalization are opposite phenomena.

5. He has wholly mistaken the influence of taxation upon interest rates.

6. He has closed his eyes to the every-day facts in the bond market where the general theory, which he opposes, is utilized in practice.

May it not, therefore, be fairly claimed that Professor Adams has failed to weaken, much less to demolish, the general theory of tax exemption through tax capitalization?

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